

VZCZCXRO8953
RR RUEHCN RUEHGH
DE RUEHUM #0028/01 0270810
ZNR UUUUU ZZH
R 270810Z JAN 10
FM AMEMBASSY ULAANBAATAR
TO RUEHC/SECSTATE WASHDC 3348
RUEHOO/CHINA POSTS COLLECTIVE
RUEHUL/AMEMBASSY SEOUL 4021
RUEHKO/AMEMBASSY TOKYO 3656
RUEHMO/AMEMBASSY MOSCOW 2825
RUEHVK/AMCONSUL VLADIVOSTOK 0495
RUEHOT/AMEMBASSY OTTAWA 0151
RUEHBY/AMEMBASSY CANBERRA 0506
RUEHTA/AMEMBASSY ASTANA 0262
RHEHAAA/NATIONAL SECURITY COUNCIL WASHINGTON DC
RUEHLMC/MILLENNIUM CHALLENGE CORP WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUCPDO/DEPT OF COMMERCE WASHINGTON DC
RUEKJCS/SECDEF WASHINGTON DC
RUCPCIM/CIMS NTDB WASHINGTON DC

UNCLAS SECTION 01 OF 14 ULAANBAATAR 000028

SENSITIVE
SIPDIS

STATE PASS USTR, USTDA, OPIC, AND EXIMBANK
STATE FOR EAP/CM AND EEB/CBA
USAID FOR ANE FOR D. WINSTON
USDOC FOR ZHEN-GONG CROSS

E.O. 12958: N/A

TAGS: [EINV](#) [ECON](#) [OPIC](#) [KTTB](#) [USTR](#) [MG](#)

SUBJECT: 2010 Mongolia Investment Climate Statement, Part 2 of 3

REF: 09 STATE 124006

ULAANBAATA 00000028 001.2 OF 014

1. As requested ref, post provides the 2010 Mongolia Investment Climate Statement. This cable, Part 2, contains sections A.5 through A.9. See septels for sections A.1-A.4 and A.10-A.16.

A.5 PERFORMANCE REQUIREMENTS AND INCENTIVES

Mongolia imposes few performance requirements on, and offers few incentives to, investors. The few requirements imposed are not onerous and do not limit foreign participation in any sector of the economy. Performance requirements are applied somewhat differently to foreign investors in a limited number of sectors. Formally quite generous to foreign investors, the current Tax Law of Mongolia (amended in 2006) offers few incentives and exemptions. While preferential tax agreements made with most foreign investors have been allowed to run their courses, the government of Mongolia (GOM) has attempted to limit both exemptions and incentives and to make sure that tax preferences offered are available to both foreign and domestic investors.

Current exemptions are granted for imports of staples as flour and for imports in certain sectors targeted for growth, such as the agriculture sector. Exemptions apply to both import duties and Mongolia's value-added tax (VAT). In addition, the GOM will extend a 10percent tax credit on case by case basis to investments in such key sectors as mining, agriculture, and infrastructure.

Foreign investors have accepted phasing out of tax incentives, because the amendments have brought some needed best practices to the tax code. These include provision for 8-year loss-carry-forwards, five-year accelerated depreciation, and more deductions for legitimate business expenses including but not limited to marketing and training expenses.

Revocation of the VAT Exemption

Investors view 2009's changes into the tax code's treatment of exemptions as something of a mixed bag. On the down side,

Mongolia's Parliament revoked an exemption available on value-added tax (VAT) taxes of 10percent on equipment used to bring a given mine into production, except on equipment to be used in the production of highly processed mining products. For example, if the Oyu Tolgoi (OT) copper-gold project were to smelt copper, imported equipment supporting production of metallic copper might qualify for an exemption from the VAT. However, to promote value-added production in Mongolia, the GOM defines the production of copper concentrate -OT's likely copper product - as non-value-added output; and so, equipment imported to develop and operate this sort of operation would not qualify for the 10percent VAT exemption.

Most jurisdictions, recognizing that most mines have long development lead times before production begins, either waive or do not tax such imports at all. Parliament, with no consultation with investors, international advisors provided by donor organizations, or even with its own tax officials, chose to impose the VAT, which immediately makes Mongolian mining costs 10percent higher than they would otherwise be, impairing competitiveness and dramatically varying from global practice.

Pro-Investment Changes to the Tax Code

On the plus side, Parliament revised both the Windfall Profit Tax (WPT) and loss-carry forward provisions. Under the old regime, the WPT imposed a 68percent tax on the profits from gold and copper mining respectively. (For more details on the WPT see Chapter A.1: Openness of Government to Foreign Investment.) The recent OT Investment Agreement entailed further amendment to the WPT as a condition precedent to its passage. OT's private investors successfully argued that they would not be able to operate OT commercially if burdened with the WPT. Consequently, Parliament amended the WPT Law: The WPT will officially end for all copper

ULAANBAATA 00000028 002.2 OF 014

concentrate and gold products in 2011.

Regarding the granting of more generous loss carry-forward provisions, as a condition precedent of passing the OT Agreement, Parliament extended the provision from two (2) years to eight (8) years after incurring a loss. Most investors find eight years sufficient for many Mongolian investments that require impose long, expensive development horizons before producing any sort of profit.

Few Restrictions on Foreign Investment

The government applies the same geographical restrictions to both foreign and domestic investors. Existing restrictions involve border security, environmental concerns, or local use rights. There are no onerous or discriminatory visas, residence, or work permits requirements imposed on American investors. Generally, foreign investors need not use local goods, services, or equity, or engage in substitution of imports. Neither foreign nor domestic businesses need purchase from local sources or export a certain percentage of output, or have access to foreign exchange in relation to their exports.

Although there remains no formal law requiring the use of local goods and services, the GOM encourages firms to do value-added production in Mongolia, especially for firms engaged in natural resource extraction. All Mongolian senior officials and politicians make in-country processing a consistent feature of their public and private policy statements regarding the development of mining. For example, the current but soon to sunset WPT applied the tax to copper concentrate, but exempted metallic copper produced in Mongolia. Recently concluded negotiations on the OT copper-gold project ended with commitments by the companies to explore copper smelting in Mongolia. Government talks on coal production constantly feature discussions of power generation and coals-to-liquid processing in Mongolia. Government plans also call for increased investment in businesses and activities that keep the "value" of a resource in Mongolia. Consequently, firms should continue to expect the GOM to press aggressively for value-added production in Mongolia.

Generally, foreign investors set their own export and production

targets without concern for government imposed targets or requirements. There is no requirement to transfer technology. As a matter of law, the government imposes no offset requirements for major procurements. Certain tenders may require bidders to agree to levels of local employment or to fund certain facilities as a condition of the tender, but as matter of course such conditions are not the normal approach of the government in its tendering and procurement policies.

Investors, not the Mongolian government, make arrangements regarding technology, intellectual property, and similar resources and may generally finance as they see fit. Foreign investors need sell no shares to Mongolian nationals. Equity stakes are generally at the complete discretion of investors, Mongolian or foreign -- with one key exception for strategic mining assets (For more detail on what constitutes a strategic mining asset see Chapter A.1: Openness of Government to Foreign Investment). Although Mongolia imposes no official statutory or regulatory requirement, the GOM, as a matter of foreign policy, sometimes negotiates restrictions on what sort of financing foreign investors may obtain and with whom those investors might partner or to whom they might sell shares or equity stakes. These restrictive covenants will most likely be imposed in certain sectors where the investment is determined to have national impact or national security concerns, especially in the key mining sector.

Regarding employment, investors can locate and hire workers without using hiring agencies-as long as hiring practices are consistent with Mongolian Labor Law. However, Mongolian law requires companies to employ Mongolian workers in certain labor categories whenever a Mongolian can perform the task as well as a foreigner. This law

ULAANBAATA 00000028 003.2 OF 014

generally applies to unskilled labor categories and not areas where a high degree of technical expertise not existing in Mongolia is required. The law does provide an escape hatch for all employers. Should an employer seek to hire a non-Mongolian laborer and cannot obtain a waiver from the Ministry of Labor for that employee, the employer can pay a fee of around USD140 per employee per month. Depending on the importance of a project, the Ministry of Labor may grant an employer a 50percent exemption of the waiver fees as an incentive.

Limited Performance Requirements

Requirements in the Petroleum and Mining Sectors

Performance requirements are sparingly imposed on investors in Mongolia with the exception of petroleum and mining exploration firms. The Petroleum Authority of Mongolia (PAM) issues petroleum exploration blocks to firms, which then agree to conduct exploration activities. The size and scope of these activities are agreed upon between PAM and are binding. If the firm fails to fulfill exploration commitments, it must pay a penalty to PAM based on the amount of hectares in the exploration block, or return the block to PAM. These procedures apply to all investors in the petroleum exploration sector.

Under the current Minerals Law of Mongolia, receiving and keeping exploration licenses depends on conducting actual exploration work. Each year exploration firms must submit a work plan and report on the execution of the previous year's performance commitments, all of which are subject to annual verification by the Minerals Authority of Mongolia (MRAM). Failure to comply with work requirements may result in fines, suspension, or even revocation of exploration rights. Work commitments expressed in terms of US dollar expenses per hectare per year:

-2nd and 3rd years miners must spend no less than US D.50 per hectare on exploration

--4th to 6th years miners must spend no less than US D1.00 per hectare on exploration

--7th to 9th years miners must spend no less than US D1.50 per hectare on exploration

In addition to these performance requirements, the law also requires holders of mining licenses for projects of strategic importance to sell no less than 10percent of company shares on the Mongolian Stock Exchange. Vaguely presented in the statute, the GOM has provided no formal clarification in law or regulation of what this provision means in practical terms or how it is to be implemented.

In 2009 the Parliament passed a new law imposing significant new controls on mining and processing uranium in Mongolia. This law created a new regulatory agency, the Nuclear Regulatory Authority of Mongolia (NRA) and a state-owned holding company, MonAtom, to hold assets that the government will acquire from current rights holders.

The law imposes several conditions:

--Immediately revokes all current uranium exploration and mining licenses and then requires all holders to register these licenses with the NRA, for a fee.

--Requires investors to accept that the Mongolian state has an absolute right to take -- without compensation -- at least 50percent of the company (as opposed to the deposit) that will develop the mine as a condition of being allowed to develop any uranium property.

--Creates a uranium-specific licensing, regulatory regime independent of the existing regulatory and legal framework existing for mineral and metal resources. Prior to the Uranium Law, exploration licenses gave their respective holders the rights to

ULAANBAATA 00000028 004.2 OF 014

discover and develop any and all mineral and metal resources discovered within that license area (this did not include petroleum resources, which are governed separately). According to GOM officials, this new law means that the state can issue a distinct license for uranium exploration on a property otherwise dedicated to other mineral and metals exploration

Requirements Imposed on Foreign Investors Only

All foreign investors must register with the Foreign Investment and Foreign trade Agency (FIFTA). The Foreign Investment Law of Mongolia requires all foreign investors to show a minimum of USD 100,000 in assets (cash, working stock, property, etc.) registered in Mongolia as a precondition for registration. In addition to this particular requirement, all foreign investors must pay an initial processing fee of some 12, 000 Mongolian tugrik or about USD 8.00. Foreign Investors must then pay a yearly prolongation fee of 6,000 Mongolian tugrik or about USD 4.00.

In addition to these fees, foreign investors must annually report on their activities for the coming year to the government through FIFTA. Businesses need not fulfill plans set out in this report, but failure to report may result in non-issuance of licenses and registrations and suspension of activities. This requirement differs from that imposed on domestic investors and businesses. Local investors have no yearly reporting requirement. Mongolians pay lower registration fees, which vary too much to say with any precision what the fees actually are.

FIFTA explains that the higher registration costs for foreign investors arise from the need to compensate for the services it provides to foreign investors, including assistance with registrations, liaison services, trouble-shooting, etc. The different reporting requirements provide the government with a clearer picture of foreign investment in Mongolia. Foreign investors are generally aware of FIFTA's arguments and largely accept them, but they question the need for annual registrations. Investors recommend that FIFTA simply charge an annual fee rather than require businesses to submit a new application each year.

Regarding reports, foreign businesses are concerned about the security of their proprietary information. Several foreign investors have claimed that agents of FIFTA routinely use or sell information on business plans and financial data. We have yet to verify these claims, but FIFTA acknowledges that data security

largely depends on the honesty of its staff, as there are few internal controls over access to the annual reports.

Tariffs

Mongolia has one of Asia's least restrictive tariff regimes. Its export and import policies do not harm or inhibit foreign investment. Low by world standards, tariffs of 5 percent on most products are applied across the board to all firms, albeit with some concerns about consistency of application and valuation. However, some non-tariff barriers, such as phyto-sanitary regulations, exist that limit both foreign and domestic competition in the fields of pharmaceutical imports and food imports and exports. The testing requirements for imported drugs, food products, chemicals, construction materials, etc., are extremely nontransparent, inconsistent, and onerous. When companies attempt to clarify what the rules for importing such products into the country are, they receive contradictory information from multiple agencies.

WTO TRIMS Requirements

Mongolia employs no measures inconsistent with WTO TRIMS requirements, nor has anyone alleged that any such violation has occurred.

A.6 RIGHT TO PRIVATE OWNERSHIP AND ESTABLISHMENT

ULAANBAATA 00000028 005.2 OF 014

Mongolia has one of Asia's most liberal ownership and establishment regimes. Unless otherwise forbidden by law, foreign and domestic businesses may establish and engage in any form of remunerative activity. All businesses can start up, buy, sell, merge; in short, do whatever they wish with their assets and firms, with exceptions in the mining and petroleum sectors.

Competition from the State-Owned Sector

Mongolia passed and implemented a competition law applying to foreign, domestic, and state-owned entities active in Mongolia. As a practical matter, competition between state-owned and private businesses has been declining for the simple reason that many parastatals have been privatized. The exceptions are the state-owned power and telecom industries, a national airline (international only at present), the national rail system (half-owned by Russia), several coal mines, and a large copper mining and concentration facility (also half-owned by Russia).

Currently, firms from Mongolia, China, Japan, Europe, Canada, and the U.S. are actively seeking opportunities for renewable and traditional power generation in Mongolia. However, few want to invest in the power generation field until the regulatory and statutory framework for private power generation firms up and tariffs are set at rates allowing profits.

Regarding its railway sector, Mongolia has no plans to privatize its existing railroad jointly held with the government of Russia, but current law does allow private firms to build, operate, and transfer new railroads to the state. Under this law several private mining companies have proposed rail links, and obtained licenses to construct these new lines from their respective coal mines to the Chinese border or to the currently operating spur of the Trans-Siberian Railroad. However, because landlocked Mongolia and its neighbors have yet to resolve transnational shipping issues, companies may not be able to access rights granted under these licenses.

Although the trend had been for the GOM to extract itself from ownership of firms and other commercial assets, both the current Minerals Law of Mongolia and the 2009 Uranium Law bring the state back into mining. (See Chapter A.1: Openness of Government to Foreign Investment for fuller discussions of both the 2009 Uranium Law and Minerals Law) Under both laws, the GOM granted itself the right to acquire equity stakes ranging from 34 percent to perhaps 100 percent of certain deposits deemed strategic for the nation. Once acquired, these assets are to be placed with one of two

state-owned management companies: Erdenes MGL, for non-uranium assets; or MonAtom for uranium resources. These companies are then mandated to use the proceeds from their respective activities for the benefit of the Mongolian people.

The role of state as an equity owner, in terms of management of revenues and operation of the mining asset, remains unclear at this point. There are some concerns over the capacity of the GOM to deal with conflicts of interest arising from its position as both regulator and owner of these strategic assets. Specifically, firms are worried that the GOM's desire to maximize local procurement, employment, and revenues may compromise the long term commercial viability of any mining project. In addition, discussions are underway to set up three new state-owned holding entities to manage assets in three priority areas -- mining, energy, and infrastructure -- then take the companies public to raise investment revenues through the capital markets.

A.7 PROTECTION OF PROPERTY RIGHTS

The right to own private, movable and immovable property is recognized under Mongolian law. Regardless of citizenship (except for land which only citizens of Mongolia can own), owners can do as they wish with their property. One can collateralize real and movable property. If debtors default on such secured loans,

ULAANBAATA 00000028 006.2 OF 014

creditors do have recourse under Mongolian law to recover debts by seizing and disposing of property offered as security. The only exceptions to this liberal environment are current mining laws, which either bar transfer of exploration and mining licenses to third parties lacking professional mining qualifications or status as a Mongolian registered entity, or which threaten to expropriate without compensation certain mineral holdings outright.

Mongolia's Current Regime to Protect Creditors

The current protection regime for creditors functions but needs reform. The legal system presents the greatest pitfalls. Although the courts recognize property rights in concept, they have a checkered record of protecting and facilitating acquisition and disposition of assets in practice. Part of the problem is ignorance of, and inexperience with, standard practices regarding land, leases, buildings, and mortgages. As noted in Chapter A.4 Dispute Settlement, some judges, largely out of ignorance of the concepts, have failed to recognize these practices. Some newly trained judges are making a good faith effort to uphold property rights, but need time to learn how to adjudicate such cases.

Mongolia's bankruptcy provisions and procedures for securing the rights of creditors need reform. Mongolian law allows for mortgages and other loan instruments backed with securitized collateral. However, rudimentary systems for determining title and liens and for collecting on debts make lending on local security risky. Banks frequently complain that onerous foreclosure rules are barely workable and unfair to creditors.

Although a system exists to register immovable property-structures and real estate-for the purpose of confirming ownership, the current system does not record existing liens on immovable property; nor does the current system record ownership and liens on movable property. Consequently, Mongolian lenders risk lending on collateral that the debtor may not actually own or which may have already been offered as security for another debt. It is hoped that a project sponsored by the Millennium Challenge Corporation to create a more modern and efficient property registration system will go some way to improving the ability of creditors and debtors to prove ownership. For details: <http://www.mca.mn>.

Overall, the legal system recognizes the concept of collateralized assets as security for loans, investment capital, or other debt-based financial mechanisms. The legal system also provides for foreclosure, but this process has proven exceptionally burdensome and time consuming. Current law bars creditors from non-judicial foreclosure, requiring them to submit all contested foreclosure actions for judicial review through Mongolia's court system. This approach slows debt collection substantially: Waits of up to 24

months for final liquidations and settlement of security are not uncommon.

Debt Collection Procedures

Even with the delays, getting a ruling is relatively easy compared to executing the court's decision. The problem is not the law but the enforcement. A judge orders the State Collection Office (SCO) to move on the assets of the debtor. The SCO orders district bailiffs to seize and turn those assets over to the state, which then distributes them to creditors. However, foreign and domestic investors claim that the state collection office and the district bailiffs frequently fail in their responsibilities to both courts and creditors.

In some cases, bailiffs refuse to enforce the court orders. The perception is that they do so because they have been bribed or otherwise suborned. Bailiffs are often local agents who fear local retribution against them and their interests if they collect in their localities. In some cases, bailiffs will not collect unless the creditor provides bodyguards during seizure of assets. Creditors also have reason to believe that the state collection office accepts payments from debtors to delay seizure of assets.

ULAANBAATA 00000028 007.2 OF 014

Protection of Intellectual Property Rights

Mongolia supports intellectual property rights (IPR) in general and has protected American rights in particular. It has joined the World Intellectual Property Organization (WIPO) and signed and ratified most treaties and conventions, including the WTO TRIPS agreement. The WIPO Internet treaties have been signed but remain un-ratified by Parliament. However, even if a convention is un-ratified, the Mongolian government and its intellectual property rights enforcer, the Intellectual Property Office of Mongolia (IPOM), make a good faith effort to honor these agreements.

Under TRIPS and Mongolian law, the Mongolian Customs Authority (MCA) and the Economic Crimes Unit of the National Police (ECU) also have an obligation to protect IPR. MCA can seize shipments at the border. The ECU has the exclusive power to conduct criminal investigations and bring criminal charges against IPR pirates. The IPOM has the administrative authority to investigate and seize fakes without court order. Of these three, the IPOM makes the most consistent good faith effort to fulfill its mandates.

Problems stem from ignorance of the importance of intellectual property to Mongolia and of the obligations imposed by TRIPS on member states. Customs still hesitates to seize shipments, saying that their statutory mandate does not allow seizure of such goods, but Mongolian statutory and constitutional laws clearly recognize that international treaty obligations in this area take precedence over local statutes and regulations. A clear legal basis exists for Customs to act, which has been recognized by elements of the Mongolian Judiciary, the Parliament, and the IPOM. Customs officers may occasionally seize fake products, but it seems that Mongolian customs law will have to be brought into formal compliance with TRIPS before Customs will fulfill its obligations. The ECU has also been lax. The ECU hesitates to investigate and prosecute IPR cases, deferring to the IPOM. Anecdotal evidence suggests that ECU officials fear political repercussions from going after IPR pirates, many of whom wield political influence.

The IPOM generally has an excellent record of protecting American trademarks, copyrights, and patents; however, tight resources limit the IPOM's ability to act. In most cases, when the U.S. Embassy in Ulaanbaatar conveys a complaint from a rights holder to the IPOM, it quickly investigates the complaint. If it judges that an abuse occurred, it will (and has in every case brought before it to date) seize the pirated products or remove faked trademarks, under administrative powers granted in Mongolian law.

We note two areas where enforcement lags. Legitimate software products are rare in Mongolia. Low per capita incomes have given rise to a thriving local market for cheap, pirated software. The

IPOM estimates pirated software constitutes at least 95percent of the market. The Office enforces the law where it can but the scale of the problem dwarfs its capacity to deal with it. The IPOM will act if we bring cases to its attention.

Pirated optical media are also readily available and subject to spotty enforcement. Mongolians produce no significant quantities of fake CD's, videos, or DVD's, but import such products from China, Russia, and elsewhere. Products are sold through numerous local outlets and sometimes broadcast on private local TV stations. The IPOM hesitates to move on TV broadcasters, most of which are connected to major government or political figures. Rather the IPOM raids local ("street") DVD and CD outlets run by poor urban youth who lack the political and economic clout of the TV broadcasters. Again, when an American raises a specific complaint, the IPOM acts on the complaint, but IPOM rarely initiates action.

Restrictive Aspects of Current Mining Laws

Minerals Law of 2006

ULAANBAATA 00000028 008.2 OF 014

The current Minerals Law of Mongolia would seem on its face to prevent transfer of exploration or mining rights to any third party lacking professional mining qualifications as determined by the Mineral Resources Authority of Mongolia (MRAM).

Under the Minerals Law, the concept of mining expertise can either qualify or disqualify any entity from acquiring, transferring, securitizing exploration and mining rights. The law has the potential to limit the ability of rights holders to seek financing, because it forbids transfer of mining licenses and exploration rights to non-qualified individuals. Consequently, a miner might not be able to offer his licenses as secured collateral to banks or to any lender lacking the professional qualifications to receive these rights if the miner defaulted on his debt obligations.

In addition, no foreign entity, in its own right, can hold any sort of mining or petroleum license; only entities registered in Mongolia under the terms of relevant company and investment laws may hold exploration and mining licenses. Should a foreign entity acquire a license as collateral or for the purpose of actual exploration or mining, and fail to create the appropriate Mongolian corporate entity to hold a given license, that failure may serve as grounds for invalidating the license. In essence, the foreign entity may lose its security or mining rights. We advise investors with specific questions regarding the current status of their respective to seek professional advice on the status of those licenses.

Uranium Law of 2009

The Uranium Law of 2009 dramatically curtails property rights protection regime protecting most exploration and mining licenses. The law imposes the following conditions upon investors in the uranium mining sector:

--Immediately revokes all current uranium exploration and mining licenses and then requires all holders to register these licenses with the NRA, for a fee.

--Requires investors to accept that the Mongolian state has an absolute right to take - without compensation - at least 51percent of the company (as opposed to the deposit) that will develop the mine as a condition of being allowed to develop any uranium property.

--Creates a uranium-specific licensing, regulatory regime independent of the existing regulatory and legal framework existing for mineral and metal resources. Prior to the Uranium Law, exploration licenses gave their respective holders the rights to discover and develop any and all mineral and metal resources discovered within that license area (this did not include petroleum resources, which are governed separately). According to GOM officials, this new law means that the state can issue a distinct license for uranium exploration on a property otherwise dedicated to

other mineral and metals exploration

To both investors and observers, this law statutorily sanctions expropriation, a concept heretofore alien to Mongolian law. Although the Minerals Law of Mongolia and other pieces of legislation officially state that the GOM must compensate rights holders for any taking, the Uranium law allows the GOM unfettered power to seize holdings with no obligation to compensate rights holders. Complicating the issue, the law conflates deposits with the companies developing those deposits, letting the GOM claim an uncompensated share of any entity that might mine the deposit. In effect, the GOM demands a free-carried, non-compensated interest of no less than 51percent of any uranium mining firm in Mongolia.

Affected uranium rights holders contested the constitutionality of these provisions before Mongolia's Constitutional Court, and lost the case. The Court upheld the law, asserting that the all minerals in the ground are the property of the Mongolian state even if separated from the ground. Legal experts with whom we consulted

ULAANBAATA 00000028 009.2 OF 014

explained that the Court seems to make the extraordinary and unprecedented claim that Mongolia's ownership extends to products created with the ore; hence the state has a "legitimate" claim on both the ore body and any company mining the resource. This theory appears to undermine the property rights of uranium investors and chips away at property rights protections granted both under the constitution and Mongolia's Minerals, Company, and Foreign Investment Laws.

A.8 TRANSPARENCY OF THE LEGISLATIVE AND REGULATORY PROCESS

Generally, Mongolia's problem is not lack of laws and regulations-Mongolia has passed more than 1,600 laws since undertaking its transition to a market economy 20 years ago-but rather, the problem is that legislators lack knowledge on what foreign and domestic investors need from the state when investing; and that they do not consult with those affected by their legislative actions. Corruption aside, the fact that laws and regulations change with little consultation creates a chaotic situation for all parties.

Problems with the Drafting Process for Legislation and Regulations

Normally, laws can be crafted in two ways. Once rare but now common, Members of Parliament and the President of Mongolia may draft their own proposals for direct submission to the Parliament. Such bills need not be submitted to the Cabinet of Ministers but can be delivered directly to the Speaker of Parliament for consideration by the relevant Standing Committee. The relevant Standing Committee may either reject the bill (in which case it dies in committee) or pass it on to the Parliament's plenary body, unaltered or revised for a general vote. More typically, Parliament or the Cabinet of Ministers requests legislative action. These institutions send such requests to the relevant ministry. The Minister relays the request to ministerial council, which in turn sends the request to the proper internal division or agency within the respective ministry, which in turn forms a working group. The working group prepares the bill, submits it for ministerial review, makes any recommended changes, and then the bill is reviewed by the full Cabinet of Ministers. Relevant ministries are asked to comment and recommend changes in the legislation.

Prior to a final vote by the Cabinet of Ministers, the National Security Council of Mongolia (NSC)-consisting of the President of Mongolia, the Prime Minister, and Speaker of Parliament-can review each piece of legislation for issues related to national security. Although the government has never clarified the legal and constitutional authority of the NSC to veto or recommend changes to draft legislation, the Cabinet to our knowledge will not and has never overruled NSC recommendations.

Once through NSC and Cabinet reviews, the bill goes to Parliament. In Parliament, the bill is vetted by the relevant Standing Committee, sent back for changes or sent on to the full Parliament for a vote. The President can veto bills, but his veto can be

overcome by a two-thirds (2/3) vote of Parliament.

For regulations, the process is truncated. The relevant minister tasks the working group that wrote the original law to draft regulations. This group submits their work to the minister who approves or recommends changes. In most cases, regulations require no Cabinet approval, and become official when the relevant incumbent minister approves them. When legislation crosses inter-ministerial boundaries, the Cabinet will authorize the most relevant ministry to supervise an inter-ministerial approval process for regulations.

The Ministry of Justice and Home Affairs (MOJHA) plays an important role in drafting both laws and regulations. MOJHA vets all statutes and regulations before they are passed for final approval. In the case of legislation, MOJHA reconciles the language and provisions of the law with both existing legislation and the constitution of Mongolia, after which the law passes to the Cabinet and then

ULAANBAATA 00000028 010.2 OF 014

Parliament. In the case of regulations, MOJHA vets the regulations to ensure consistency with current laws and provisions of the constitution. In effect, MOJHA can either modify or even veto legal or regulatory provisions that it finds inconsistent with the statutes and constitution.

System lacks Transparency

Absent from these drafting processes is a statutory, systematic, transparent review of legislation or regulations by stakeholders and the public. Ministerial initiatives are not publicized until the draft passes out of a given ministry to the full Cabinet. Typically, the full Cabinet discusses and passes bills on to Parliament, without public input or consultations. Parliament itself issues neither a formal calendar nor routinely announces or opens its standing committees or full chamber hearings to the public. While Parliament at the beginning of each session announces a list of bills to be considered during the session, this list is very general and often amended. New legislation is commonly introduced, discussed and passed without public announcement or consideration. For example, in 2006, Parliament passed the (since-amended) Wind Fall Profits Tax Law bill in six days without consulting any business, NGO, or other entity about the impact and desirability of the bill. In 2007, Parliament significantly amended the Law on State Procurement within thirty days without any public notification or comment regarding new limits on competitive, transparent bidding practices and limits on access tender opportunities to foreign bidders. In 2009, Parliament passed legislation threatening property rights in the mining sector that many view as expropriatory and revoked key tax exemptions affecting major mining and construction projects, all with no formal or informal public comment and review.

The U.S. Embassy in Ulaanbaatar and foreign and domestic investors have repeatedly urged the Mongolian government to utilize the government's Open Government web site to post draft and pending legislation for public consultation and review before it is finalized and sent to Parliament. Over the past couple of years, we have noticed some improvement in the timeliness and completeness of the postings.

To supplement this effort, the U.S. Embassy and local business organizations have jointly created an informal system to identify legislation and regulations under review. Once identified, we meet with working groups, provide information on how other nations have handled such legislation, share stakeholders' points of view, and widely distribute publicly available draft bills, preferably before they reach a minister's desk. Should a piece of vital legislation pass on to the Minister, Cabinet, or Parliament, these non-government organizations are prepared to lobby at the appropriate level. Over the last three years we have found that many agencies and Members of Parliament welcome our advice and information, particularly if given in a non-confrontational way that respects Mongolia's political process and right to deliberate.

Regulators resist consultation when it comes to implementation. Bureaucrats are only slowly becoming comfortable with the concepts

and practices of broad, public consultation and information sharing with their own citizens, let alone foreigners. Many times businesses ask for a clear copy of the current regulations, only to be met with blank stares or outright refusals. The government has long acknowledged that the Soviet-era State Secrets Law requires substantial amendment. Currently, most government documents-including administrative regulations affecting investments and business activities-can be technically classified as "state secrets" not for release to the public. This technicality allows bureaucrats and regulators a convenient excuse to deny requests for information or, more commonly, to demand extra-legal fees to provide documents. The legacy of secrecy has also resulted in cases where government officials themselves cannot get up-to-date copies of the rules. Mongolia is considering a freedom of information law for several years, but it remains in its formative stages.

ULAANBAATA 00000028 011.2 OF 014

High officials acknowledge the value of, and need for, a more open, transparent system. While laws are easy to fix, the behavior of individual bureaucrats, Members of Parliament, and the judiciary will only gradually change, with training and experience. Already a younger generation of professionals, many trained abroad or during Mongolia's democratic era, is taking hold and moving into senior positions of authority. This bodes well for Mongolia's continuing transition to a private sector-led, open, market economy underpinned by good government and corporate governance.

The Impact of NGOS and Private Sector Associations on GOM Policy

The Mongolian government actively protects its prerogatives to legislate and regulate economic activities in its domain. While NGOs and private sector associations have wide latitude to run their activities, the government of Mongolia has never allowed any non-governmental entity-be it business, civil society, trade union, etc.-to serve more than an advisory role over the formulation and execution of both laws and rules, which also applies to setting standards for various industries. Based on experience, the GOM will routinely resist any expanded role for civil society and NGOs. This unarticulated but tacit policy of the government of Mongolia applies to both domestic and foreign entities.

Laws, Regulations, and Policies that Impede FDI

While the GOM supports FDI and domestic investment, individual agencies and elements of the judiciary reportedly use their respective powers to hinder investments into such sectors as meat production, telecommunications, aviation, or pharmaceuticals. Both domestic and foreign investors report similar abuses of inspections, permits, and licenses by Mongolian regulatory agencies. However, we generally note no consistent, systematic pattern of abuse consistently initiated by either government or private Mongolian entities aimed against foreign investors in general or against U.S. investment in particular. The impediments more often than not are opportunistic attempts by individuals to misuse contacts to harass U.S. and other foreign investors with whom the Mongolian entity is in dispute.

Alternatively, other reports suggest that Mongolians use connections to well-placed regulators at all levels to extract extra-legal payments from both foreign and domestic businesses or otherwise hinder their work. In the latter case the general approach is to demand some sort of payment in lieu of not enforcing work, environmental, tax, health and safety rules, otherwise imposing the full weight of a contradictory mix of Soviet Era and the current reformed rules on the firm. Most foreign businesses refuse to pay bribes, and in turn accept the punitive inspections, concede to some of the violations found, and contest the rest in the City Administrative Court. In our experience companies that show resolve against such predatory abuse of statutory and regulatory power will face impediments at the start; but these usually ease over time as state agents look for easier targets.

Although we have note no systemic and routine abuse of Mongolia's legal system to hinder FDI and investors, a worrisome trend affecting implementation of Mongolia's requirement for exit visas by

both Mongolian public and private entities to exert pressure on foreign investors to settle commercial disputes. Required, valid exit visas are normally issued pro forma at the port of departure (e.g. the international airport), but may be denied for a variety of reasons including civil disputes, pending criminal investigation, or for immigration violations. The law does not allow authorities to distinguish a criminal and civil case when detaining a person. If denied for a civil dispute, the visa may not be issued until either the dispute is resolved administratively or a court has rendered a decision. Neither current law nor regulations establish a clear process or time-table for resolution. In fact, the Mongolian government maintains the right to detain foreign citizens indefinitely without appeal until the situation has been

ULAANBAATA 00000028 012.2 OF 014

resolved.

Research into issue has revealed that investors from countries other than the U.S. are affected by abuse of the exit-visa system. All cases have a similar profile. A foreign investor has a commercial dispute with a Mongolian entity, often involving assets, management practices, or contract compliance. The Mongolian entities respond by filing either civil or criminal charges with local police or prosecutorial authority. It is important to note that at this point there need be no actual arrest warrant or any sort of official determination that charges are warranted: Mere complaint by an aggrieved party is sufficient grounds to deny exit.

An investor in this situation is effectively detained in Mongolia indefinitely. Some foreign investors have resolved the impasse by settling, thereby allowing them to depart Mongolia. If unwilling to settle, the foreign investor will have to undergo the full investigatory process, which may lead to a court action. Investigations commonly take up to six months, and in one case an American citizen has been denied an exit visa for two years pending a criminal investigation into a failed business deal. In addition, even if a dispute seems settled, it can be filed in the same venue again -- if the local police and prosecutors are willing -- or in a different venue. In one case, an American citizen has been denied an exit visa for over two years pending a criminal investigation into a failed business deal with the Government of Mongolia.

We note that Mongolian investors are not subject to similar impositions of their immigration codes when involved in commercial disputes. Mongolian citizens do not require exit visas to depart Mongolia and can only be denied exit with a pending arrest warrant.

A.9 EFFICIENT CAPITAL MARKETS AND PORTFOLIO INVESTMENT

Mongolia currently lacks the experience and expertise needed to sustain portfolio investments. It has no regulatory apparatus for these activities, and both the state and private entities are just beginning to engage in them. However, Mongolia has active capital markets. The government of Mongolia (GOM) imposes few restraints on the flow of capital in any of its markets. Multilateral institutions, particularly the International Monetary Fund, have typically found the regime too loose, especially in the crucial banking sector.

Although the government has clear rules about capital reserve requirements, loan practices, and banking management practices, the Bank of Mongolia (BOM), Mongolia's central bank, has historically resisted restraining credit flows and interfering with operations at Mongolia's commercial banks, even when the need to intervene has been apparent. However, in response to the severe impact of the ongoing global financial crisis on Mongolia's banking sector, the BOM is striving to improve its capacity to deal with those insolvent banks and improperly managed banks that have impaired the health of Mongolia's financial system. To illustrate, two (2) of the country's 16 banks are currently in receivership, and additional consolidation under BOM supervision is likely.

Capital and Currency Markets

The global economic crisis savaged Mongolia's currency, capital, and equity markets. While the currency had proved resilient, holding

its value against most international currencies, it fell some 40 percent against the U.S. dollar from late 2008 into spring 2009, as the worst of the crisis hit. It has remained relatively stable and even resilient since then. The currency's resiliency has largely been attributed to the commodities boom, which saw Mongolia selling such raw materials as copper, gold, and coal, primarily to China. In mid 2008, the commodity markets began to cool and Mongolia's foreign trade began to fall, leading to growing trade deficit as imports no longer balanced or exceeded exports. Subsequently, once the tugrik began to slide relative to the U.S. dollar, import-related trade was affected as well.

ULAANBAATA 00000028 013.2 OF 014

Complicating matters, major banks and other institutions that formally had access to international capital flows (in the form of dollars, yen, Renmimbi, Euros, etc, which were parked in high-interest yielding tugrik accounts), found in-flows reversing as foreign depositors repatriated their funds, either because these entities needed the money to weather their own financial crises or feared that the tugrik's collapse would eat away the value of their deposits. Banks no longer had access to easy capital and liquidity, and began and continue to restrict lending to almost all clients, who in turn found they lacked funds to finance construction projects, trade, and other activities.

After several months of tapping reserves to slow the tugrik's decline, Mongol Bank curtailed such infusions. Instead, the Bank sells dollars into the system by auction to the local commercial banks and lets the market decide the value of the exchange rate rather than attempting to set the rate. . In addition, Parliament closed a loophole that allowed local transactions to occur in any currency desired. Now, all domestic transactions must be conducted in Mongolia's national currency, the Tugrik, excepting those entities allowed specific waivers as determined by the Mongolian central bank, the Bank of Mongolia. The move was intended to bolster the value of the Tugrik by increasing demand for the currency. Overall liquidity is sufficient but affordable capital remains scarce. Local credit interest rates for customers range from 12percent for the most credit worthy to perhaps 90percent per annum (or more) for the least. Foreign investors can easily tap into these domestic capital markets; however, they seldom do, because they can do better abroad or better locally by simply taking on an equity investor, Mongolian or otherwise.

Equity Markets

Investors do not use stocks to raise equity for investment but to gain control of companies listed on the exchange. As most of the firms have been bought up, the market sees little trading.

Mongolian firms do not use shareholding relationships to restrict foreign investment at this point. Part of this arises from lack of experience with such devices. It also arises from the fact that Mongolians prefer to concentrate ownership in their own hands, rather than disperse it through complicated shareholding relationships. They perceive such devices as weakening their ability to control the companies, which is more important than safeguarding the firm from foreign or domestic raiders or raising capital for investment. If a foreign company wanted to purchase a Mongolian firm, the foreign entity would have to contact the shareholders and buy them out. These could not be hostile takeovers, because few outstanding shares remain on the market to buy. Eager to take on equity partners or sell businesses entirely, the Mongolians would employ few defenses beyond sharp negotiating.

The current Minerals Law of Mongolia contains a provision that requires that holders of mining licenses for projects of strategic importance must sell no less than 10percent of the resulting entity's shares on the Mongolian Stock Exchange. Vaguely presented in the statute, what this new provision means in practical terms and how it is to be implemented has yet to be spelled out in regulation.

The Banking Sector

Weakness in Mongolia's banking sector concerns all players,

including the International Monetary Fund (IMF: <http://www.imf.org>).

Small by American standards, the total assets of Mongolia's remaining fourteen (14) commercial banks (down from 16 in 2008) adds up to just around USD2 billion. The system has been through massive changes since the Soviet era, during which the banking system was divided into several different units. This early system failed through mismanagement and commercial naivety in the mid-90s, but over the last decade has become more sophisticated and somewhat better managed.

ULAANBAATA 00000028 014.2 OF 014

Mongolia has three large, generally well-regarded banks owned primarily by Japanese and Mongolian interests respectively. They follow international standards for prudent capital reserve requirements, have conservative lending policies, up-to-date banking technology, and are generally well managed. As the global financial storm has descended on Mongolia's banking sector, these banks have weathered it well - so far.

However, concerns remain among bankers and the sector's observers about the effectiveness of Mongolia's legal and regulatory environment. As with many issues in Mongolia, the problem is not lack of laws or procedures but the will and capacity of the regulator, BOM, to supervise and execute mandated functions, particularly in regard to capital reserve requirements and non-performing loans.

From 1999 through late 2008, BOM consistently refused to close any commercial bank for insolvency or malpractice. In late 2008, Mongol Bank took Mongolia's fourth largest bank into receivership. Most deposits were guaranteed and their depositors paid out at a cost of around USD 150 million -- not an inconsequential sum in an economy with a USD 5 billion per annum GDP. In 2009, Mongolia's fifth largest bank went into receivership, and three (3) other mid-tier banks are at the center of widespread discussion of future consolidation.

The BOM and Mongolia's financial system have so far endured the crisis. However, most observers note that the insolvent banks had shown signs of mismanagement, non-performing loans, and ill-liquidity for several years before the BOM moved to safeguard depositors and the financial sector. They argue further that the BOM withheld effective supervision fearing that closure would signal weakness to, and spur panic among, the general public; and because of interference on the part of those whose financial interests in the troubled banks would have been threatened by regulatory action.

The latest crisis has spurred the BOM to develop a short run plan to identify and close insolvent banks while preserving the integrity of financial system. Reserve requirements will be raised to deal with the on-going non-performing loan problem, too. Beyond this triage, the BOM is in the process of instituting long-term reforms to enhance its ability to supervise the banking system; however, such reform depends on Parliament to amend both Mongolia's banking and banking supervision laws, a process that may be completed by mid-2010.

ADDELTON